

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Runner Analyst: Jeff Garnier Bill Number: AB 628
Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: February 19, 2003
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Withholding on Sale of California Real Estate Not Required if from Sole Proprietor of Residential House Construction Trade or Business

SUMMARY

This bill would exempt an individual from the 3^{1/3}% real estate withholding requirement if:

- the individual selling the property is a sole proprietor that constructs and sells residential houses, and
- the real property is treated as inventory for personal income tax purposes in the hands of the seller.

PURPOSE OF THE BILL

The author's staff has indicated the purpose of the bill is clarify the intent of the real estate withholding enacted last year be limited to non-business sale transactions.

EFFECTIVE/OPERATIVE DATE

These changes are effective on January 1, 2004 and the bill specifically provides that they would apply to dispositions of real property on or after January 1, 2004.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation concerns discussed in this analysis.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, 10% of the amount realized on the disposition of a U.S. real property interest must be withheld when a foreign investor disposes of that interest in real property. The withholding obligation is generally imposed on the buyer or the withholding agent, either of whom must report the amounts withheld and pay them to the Internal Revenue Service.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director
Gerald H. Goldberg

Date
03/19/2003

Under state law, when California real estate is sold, buyers are required to withhold 3 1/3% of the total sales price if certain conditions are met.

Generally, the buyer is required to withhold when purchasing California real property where the seller is:

- An individual or a trust.
- A corporation that has no permanent place of business in California immediately after the sale of the real property.

For individual sellers, withholding is not required if any of the following are met:

1. The total sales price of the California real property is \$100,000 or less,
2. The buyer did not receive written notification of the withholding requirements,
3. A corporate mortgagee or a beneficiary under a deed of trust is acquiring the property in foreclosure,
4. The seller certifies under penalties of perjury that:
 - The property conveyed was the seller's principal residence as defined under Internal Revenue Code (IRC) Section 121,
 - The property is being exchanged under the like-kind exchange provisions of IRC 1031,
 - The property was involuntarily converted or sold as defined under IRC 1033, or
 - The sale results in a loss to the seller.
5. The amount of withholding may be modified if income from the property that is sold is taken into account under the installment method of accounting.

THIS BILL

This bill would exempt an individual from the 3 1/3% real estate withholding requirement if:

- (1) the individual selling the property is a sole proprietor in the trade or business of construction and sale of residential houses, and
- (2) the real property disposed of was held by the seller for sale to customers in the ordinary course of the seller's trade or business.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

Builders may be involved in more than one construction-related trade or business. They may also build commercial properties or subdivide land. It is unclear if the individual will have to build the home to be exempt from withholding. Additionally, it is unclear if a builder that constructs office buildings, who is also in the trade or business of building residential houses, would be exempt from withholding in regards to a sale of an office building. Homebuilders also sometimes buy large tracts of land with one or more single-family residences on the property. If the homebuilder subdivided the tracts, sold the single-family residences, and developed the remaining parcels, it is unclear whether the individual would be exempt from withholding on the resale of the existing single-family residences.

Existing law provides that most exemptions from real estate withholding must be certified by the seller, under penalty of perjury, to be true and correct. This bill does require the seller to certify that they are in the trade or business of building and selling homes and that the property sold was held by the builder for sale to customers in the ordinary course of that trade or business.

LEGISLATIVE HISTORY

AB 2065 (Oropeza, Stats. 2002, Ch. 488) expanded the real estate withholding provisions to residents and converted the waiver process for individuals into a certification process.

AB 1338 (Chavez, 2003) would:

- Modify the real estate withholding provisions to permit withholding of 9.3% of the gain on the transaction in lieu of $3\frac{1}{3}\%$ of the sales price,
- Require withholding on the portion of any gain from the sale of a principal residence that is not excluded from taxable income,
- Revise the withholding requirements on certain corporations to match the requirements applicable to individuals,
- Make the real estate escrow person (REEP) jointly and severally liable for real estate withholding and remove a provision that prohibits a penalty being assessed on the REEP for failure to properly withhold if the seller reports the gain on the sale of the property and pays the proper amount of tax, and
- Clarify that certain non-taxable transfers of real property are not subject to withholding.

AB 1338 is presently at the Assembly Desk.

AB 1490 (Benoit, 2003) would eliminate real estate withholding on all residences of the seller, whether the residence qualifies as the seller's residence or not. This bill is presently at the Assembly Desk.

OTHER STATES' INFORMATION

The laws of *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. No statutes were found for these states where a withholding requirement is imposed on the sale of real property similar to California's present real estate withholding law or proposed by this bill.

FISCAL IMPACT

If the implementation concerns were addressed, this bill would not significantly impact the department's costs and operations.

ECONOMIC IMPACT

Revenue Cash Flow Estimate

This bill would result in cash-flow losses as follows:

Estimated Cash-Flow* Impact of AB 628 As Introduced February 19, 2003 Effective for tax years BOA 1/1/2004 Enacted after 6/30/2003 \$ Millions			
2003-04	2004-05	2005-06	2006-07
-\$1	Negligible loss+	Negligible loss+	Negligible loss+

* Ultimate tax liabilities are not affected, only the timing of payments.

+ Less than \$250,000.

Cash-flow Estimate Discussion

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

This bill is expected to affect only the timing of payments, not ultimate tax liabilities. The bill also affects only builders who hold titles of residential houses at the time of escrow.

The cash-flow impact of this bill was derived as follows. First, the gross receipts of all sole proprietors with NAICS code of 233200 (residential building construction) in 2000 were estimated using the department's personal income tax sample. This amount is extrapolated to 2004 based on projection of real estate growth. The gross cash-flow reduction is estimated as 3.3% of the qualified amount. This gross amount is adjusted downward for qualifying amount, fiscal year differences, offsetting estimate payments under current law, and other prepayments.

This cash-flow loss is largely a one-time event. The term "cash-flow" gain or loss means that while ultimate tax liabilities are not changed, the timing of tax payments through withholding relative to current law by this bill will be affected.

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